Multistate Tax Commission

Hearing Officer's Report

Recommendation Concerning the Proposed Revision of the MTC's Allocation and Apportionment Regulation IV.1(b) Setting Forth Principles for Determining the Existence of a Unitary Business

September 10, 2003

I. Introduction.

The Multistate Tax Commission through its Uniformity Committee has over a several year period developed a proposed regulation setting forth principles for determining the existence of a unitary business based on current U.S. Supreme Court law.

At its June 13, 2003, meeting, the Executive Committee approved the draft proposal for public hearings.

Frank Katz was appointed hearing officer and conducted public hearings on August 7, 2003 at the Hall of the States in Washington DC and on August 11, 2003 at the State Office Building in Oakland California. Exhibit A is the appointment of Katz. Exhibit B is the Notice of Public Hearing. Exhibit C is the Certification of Loretta King affirming proper dissemination of the Notice

II. The Proposal.

The proposal sets forth the conceptual basis of the unitary business principle: the interdependency, integration and interrelation of separate parts of single business entity or of a commonly controlled group of business entities operating in several states that provide a synergy and sharing or exchange of value among them that sufficiently connects the entities together to permit states to use the total value or total income of the entire unitary business as a starting point from which to apportion the share of value or income attributable to a single state. The flow of value among business entities characterizing a unitary business is evidenced by factors such as those described by the United States Supreme Court in *Mobil Oil Corp v. Vermont*, 445 U.S 425 (1980): functional integration, centralization of management and economies of scale.

A copy of the Proposal is attached to Exhibit B, the Notice of Public Hearing.

III. Summary of Written Responses.

Two written comments were submitted.

Roy E. Crawford, special counsel with the HellerEhrman law firm in San Francisco, submitted comments, attached as Exhibit D:

- He wonders whether "person" in the definitions of commonly controlled group is intended to exclude foreign governments. I believe yes.
- He proposes including in groups that are combinable, "closely knit shareholder groups of individuals, no single member of which owns more than 50%." Only if there is a family relationship can such a group be combined under the proposed regulation. Although there are other connections sometimes even more important than "family," the problem is in identifying what would constitute such a "closely knit group of individuals."
- He expresses concern about the situation in which ownership of stock is retained but the actual voting power is transferred. His proposed solution follows substantially what the proposal sets out.

Michael Brownell from California Franchise Tax Board submitted a series of comments, attached as Exhibit E, that reflect his views, not those of the FTB. He raises the issue of where this regulation should fit in with MTC's Allocation and Apportionment Regulations. Should it be part of the recently approved revision to the business income regulation? He notes internal inconsistencies in subsection enumerations. He suggests that we use the phrase "commonly controlled group" rather than "commonly owned or controlled group" to be consistent with the term of art used in Section IV. Mr. Brownell then suggests a number of changes in Section IV reflecting changes that he is proposing to the FTB for the California statute. Most of the suggestions are simply clarification of slightly ambiguous language and should be adopted. A couple tighten up the family ownership language to prevent evasion. He also suggests language clarifying treatment of limited partnerships. Your hearing officer proposes adoption of virtually all of Mr. Brownell's suggestions.

IV. Summary of Public Comment at Hearings

1. August 7, 2003 Hearing.

At the August 7th hearing in Washington DC, two comments were received. Jamie Yesnowitz of Deloitte & Touche asked why, in Section II(B)(2)(a), the indicia of centralized management included only common officers and not

common directors. Roxanne Bland, Counsel of the MTC responded that the officers have day to day responsibility for operations of a business, so common officers were of greater significance than common directors.

Steve Kranz of the Council on State Taxation questioned whether centralized administration functions, listed as an indicia for economies of scale in Section II(B)(3)(b), were alone sufficient to determine that business entities were part of a unitary business. Mary Loftsgard of the North Dakota Department of Revenue responded that whether such economies of scale of centralized administrative functions proved a unitary business relationship depends on the facts.

Steve Kranz also questioned whether establishing the existence of a unitary business relationship had any implications for nexus.

2. August 11, 2003 Hearing.

At the August 11th hearing in Oakland, CA, a representative from a major accounting firm and a representative from a tax agency commented at length about the proposal. The major focus of the discussion concerned questions about whether centralized management really provides a good basis for determining the existence of a unitary business. All conceded that centralized management provides the potential for the kind of sharing of value fundamental to the existence of a unitary business. But is the potential enough? *F.W. Woolworth v. Taxation and Revenue Department* was cited as an example of where the Supreme Court said that potential alone was not enough.

One of the problems raised about using centralized management as a basis for finding a unitary business is difficulties of proof. There are often no hard documentary links that indicate centralized management or its lack. From the taxpayer's perspective, an auditor's say-so puts the burden on the taxpayer of disproving the allegation often through costly litigation. From the tax agency's perspective, the lack of hard facts leaves the taxpayer able to present witnesses to testify to centralized management—or its lack—based on numerous non-documented occurrences like telephone calls and meetings.

Moreover, it was asserted that this psychoanalyzing of a business does not say much about flow of value. Should unitariness depend on the personality type of the CEO? Further, the larger the organization, the less like that management controls the day to day operation. This makes the small diverse businesses operated by a single owner likely to be considered unitary and leaves the large multinational with an argument that because it lacks sufficiently centralized management, it is not unitary.

Finally, the commentators raised the concern that inquiries into management practices are sometimes offensive and intrusive to taxpayers, particularly those in the international arena. The international conglomerates that were long the focus of the centralized management arguments to prove a unitary business are much less prominent today, it was suggested, as businesses realize the dangers of venturing outside their area of competence.

The commentators complimented the MTC for a clear accurate summation in the proposed regulation of current Supreme Court standards of what constitutes a unitary business. They raised the question, however, of whether a regulation that sets for the constitutional limits of what constitutes a unitary business ultimately provides helpful guidelines for business or tax agencies. Might it be better, they asked, to set more of a bright-line standard somewhat within the outer edge of the constitutional limits to provide greater clarity.

The drawback from constitutional limits that was suggested was to use the more factually definite functional integration factors with an option for taxpayers to choose instead the more convenient federal consolidated group with such choice locked in for ten years.

V. Hearing Officer Recommendations

The proposal received a largely favorable reception at the hearings. Those who commented thought that the proposal clearly and accurately reflected Supreme Court law on the standards for determining the existence of a unitary business. But the proposal did not provide a bright-line formula or the degree of certainty that some wished. That failing inevitably inheres in any proposal that attempts to limn a constitutional-limits standard. The Commission will need to decide whether it wishes to proceed with this proposal that leaves states the maximum flexibility to combined entities into a single unitary business so long as they meet due process standards or wishes consider a proposal that is somewhat more restrictive on the states but provides a clearer and perhaps more easily measured standard.

The factors that evidence a flow of value reflected in the proposal are those set forth in Supreme Court case law. No one complained about the functional integration factors. Both centralized management and economies of scale factors were questioned as noted above. The reference to the *Woolworth* case with the distinction between the "potential" to create a unitary business and the actual existence of a unitary business focuses that discussion. The "potential" that was referred to in *Woolworth* was the potential to operate as a unitary business that derived from the parent's *ownership* of the subsidiaries, not from centralized management. The *Woolworth* Court said ownership alone was not enough and focused on whether there was centralized man-

agement. The Court found insufficient centralized management to justify a unitary finding. The battle over whether ownership alone is sufficient for a unitary finding was definitively lost in *Allied-Signal*. There was a tendency at the Oakland hearing to suggest that centralized management provides an *opportunity* for a unitary business and the kind of flow of value that makes combined reporting necessary to properly reflect the income earned within a state, but it doesn't show the flow of value itself. While that may be true, the whole purpose of the unitary business principle is not to require a separate showing of transfer pricing or income shifting so long as functional integration, centralized management or economies of scale demonstrate that the opportunity exists.

Your hearing officer disagrees with those who criticized reliance on centralized management and centralized administrative functions as factors establishing a unitary relationship. Centralized administrative functions can permit considerable expense shifting among commonly owned diverse businesses. The more profitable entity can pay a disproportionate share of a centralized personnel system, accounting system, or legal staff, creating a significant flow of value between the businesses.

But in some sense, the control inherent in the "commonly controlled" requirement for a unitary business provides all the potentiality for shifting of income among entities that is reflected in using centralized management factors or centralized administrative functions to determine the existence of a unitary business. For that reason, the idea of giving corporations the option of filing on the basis of ownership alone—that is by using the federal consolidated group—has a great deal of appeal. The Commission may wish to consider future regulation that permits that option, with a commitment to retain that method of filing for a substantial time period, and accompany it with a drawback from the constitutional limits by use of the more objective functional integration factors from the *Mobil* case.

If the Commission wishes to proceed along the lines of the proposal as submitted to hearing applying the factors evidencing a unitary business to the fullest extent allowed by the U.S. Constitution, your Hearing Officer believes the proposal to be sound and would recommend its submission to a Bylaw 7 Survey with certain modifications. Those modifications are attached as Exhibit F.

The modifications contain substantial renumbering of the sections, subsections, paragraphs and subparagraphs. It is evident that the proposal replaces the MTC Allocation and Apportionment Regulation IV.1.(b) as it repeats most of the language of that section in various places. The renumber is intended to be consistent with the balance of the Allocation and Apportionment Regula-

tion. Coincidentally, and conveniently, the renumbering now makes the numbering in Section IV (now Section (4)) similar to that of California Revenue and Taxation Code Section 25105 from which it is derived.

The modifications also suggest certain revisions to Section IV. The descriptive Comments to those modifications are those of Mike Brownell.

Respectfully submitted September 10, 2003,

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Frank D. Katz

Exhibits Attached to the Report of the Hearing Officer
Concerning a Proposed Regulation Setting Forth Principles for
Determining the Existence of a Unitary Business

Exhibit A: Memorandum of Appointment of Hearing Officer

Exhibit B: Notice of Public Hearing and Proposed Regulation.

Exhibit C: Certificate of Loretta King attesting to proper notice of hearing.

Exhibit D: Written Comments of Roy E. Crawford, Special Counsel at the HellerEhrman law firm.

Exhibit E: Written Comments from Michael Brownell of the California Franchise Tax Board

Exhibit F: Suggested Modification of the Proposed Regulation.

Multistate Tax Commission Memorandum
States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

Memorandum of Appointment of Hearing Officer

To: Record of the Hearing on Proposed Principles for Determining the Existence of a Unitary Business

From: Dan R. Bucks, Executive Director

Date: June 18, 2003

Re: Appointment of Hearing Officer for Proposed Principles for Determining the Existence of a Unitary Business

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The Executive Committee of the Multistate Tax Commission approved at its meeting held June 12, 2003, the conduct of a public hearing on Proposed Principles for Determining the Existence of a Unitary Business. Pursuant to that action and the Multistate Tax Compact, I hereby appoint Frank D. Katz, General Counsel, as Hearing Officer for this proposal. I further request that he proceed with the conduct of this hearing.

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Dan R. Bucks, Executive Director

EXHIBIT A

NOTICE OF PUBLIC HEARINGS
Regarding
Proposed Regulation Setting Forth Principles for Determining the Existence of a Unitary Business

The MULTISTATE TAX COMMISSION will conduct two public hearings to obtain comments from interested parties on a proposed regulation setting forth the principles for determining the existence of a unitary business. The Proposal sets forth the conceptual basis for determining what a unitary business is and the principles by which it can be determined whether business entities are unitary. The Proposal is appended to this Notice as Exhibit A.

The hearings on the Proposal are scheduled for:

THURSDAY, AUGUST 7, 2003, 2:00 P.M.
Hall of the States, Conference Room 231
444 No. Capitol Street N.W.
Washington DC 20001

MONDAY, AUGUST 11, 2003, 1:30 P.M.
Oakland State Office Building
Room 7, Second Floor
1515 Clay Street
Oakland CA 94612

All comments received as part of the hearing process will be set forth in a hearing officer's report that will be submitted to the MTC Executive Committee. The MTC Executive Committee will read what you say and then will consider the Proposal for appropriate action. *See* The MTC's Uniformity Recommendation Development Process at step seven, available at www.mtc.gov/uniform/9steps.htm

The hearing officer for this matter is Frank D. Katz. Please submit all questions, comments and correspondence regarding this hearing matter to: Frank D. Katz, Multistate Tax Commission, 444 N. Capitol Street, N.W., Suite 425, Washington, D.C. 20001-1538, Phone: (505) 982 4351, Fax: (505) 982 4379, E-mail: fkatz@mtc.gov

All interested parties are invited to participate in these public hearings. Parties wishing to make formal oral presentations are requested to notify the hearing officer in writing at least two (2) working days prior to the hearing date. Written comments are acceptable and encouraged. They may be submitted at any time prior to or on the hearing dates or by such later date as may be announced at the closing of the public hearings. Interested parties may participate by telephone. Please contact the hearing officer for specific instructions on how to connect by telephone.

EXHIBIT B

Exhibit A

Multistate Tax Commission

PROPOSED REGULATION SETTING FORTH PRINCIPLES FOR DETERMINING THE EXISTENCE OF A UNITARY BUSINESS

Approved for Public Hearing by the Executive Committee on June 13, 2003

I. UNITARY BUSINESS PRINCIPLE

A. *The Concept of a Unitary Business*. A unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly owned or controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. This flow of value to a business entity located in this state that comes from being part of a unitary business conducted both within and without this State is what provides the constitutional due process "definite link and minimum connection" necessary for this state to apportion business income of the unitary business, even if that income arises in part from activities conducted outside the state. The business income of the unitary business is then apportioned to this state using an apportionment percentage provided by **[insert your state statute]**.

This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contributes to the activities of another business *or* are dependent upon the activities of another business, those businesses are part of a unitary business.

B. *Constitutional Requirement for a Unitary Business.* The sharing or exchange of value described in subsection (A) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no *operational* relationship to the unitary business.

In this State, the unitary business principle shall be applied to the fullest extent allowed by the U.S. Constitution. The unitary business

principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of such activities or entities would not be allowed by the U.S. Constitution.

C. *Separate Trades or Businesses Conducted within a Single Entity.* A single entity may have more than one unitary business. In such cases it is necessary to determine the business, or apportionable, income attributable to each separate unitary business as well as its nonbusiness income, which is specifically allocated. The business income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

D. *Unitary Business Unaffected by Formal Business Organization.* A unitary business may exist within a single business entity or among a group of commonly owned or controlled business entities. The scope of what is included in a commonly owned or controlled group of business entities is set forth in Section V below.

II. DETERMINATION OF A UNITARY BUSINESS

A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. [RESERVED: See regulation concerning passive holding companies for special rules that govern the determination of whether a pure or passive holding company constitutes a part of a unitary business with one or more affiliates conducting active business operations.] Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation.

A. *Classification of Particular Business Operations.* A particular business operation may be suggestive of one or more of the factors mentioned above.

B. *Description and Illustration of Functional Integration, Centralization of Management and Economies of Scale.*

1. *Functional integration:* Functional integration refers to transfers between, or pooling among, business activities that sig-

nificantly affect the operation of the business activities. Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that can support the finding of functional integration. The order of the list does not establish a hierarchy of importance.

a. Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and/or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among business entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales, because such sales can represent an assured market for the seller or an assured source of supply for the purchaser.

b. *Common Marketing.* The sharing of common marketing features among business entities is an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the business entities' products, services, or intangibles are distributed or sold to a common customer, when the business entities use a common trade name or other common identification, or when the business entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. (Such activity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)

c. *Transfer or Pooling of Technical Information or Intellectual Property*. Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development, provide evidence of functional integration when the matter transferred is significant to the businesses' operations.

d. *Common Distribution Syste*m. Use of a common distribution system by the business entities, under which inventory control and accounting, storage, trafficking, and/or transportation are controlled through a common network provides evidence of functional integration.

e. *Common Purchasing*. Common purchasing of substantial quantities of products, services, or intangibles from the same source by the business entities, particularly where the purchasing results in significant cost savings or where the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, provides evidence of functional integration.

f. *Common or Intercompany Financing*. Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business entities for the benefit of another business entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender does not necessarily provide evidence of functional integration. *(See* below for discussion of centralization of management.)

2. *Centralization of Management*. Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single business entity to another division within a business en-

tity, or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

a. *Facts Providing Evidence of Centralization of Management*. Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are common directors.

b. *Stewardship Distinguished.* Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.

3. *Economies of Scale.* Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that can support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.

a. *Centralized Purchasing.* Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.

b. *Centralized Administrative Functions.* The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit administration, in common among the parts of the business may result in some degree of economies of scale. A business entity that secures savings in the performance of corporate administrative services due to its affiliation with other business entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, provides evidence of economies of scale.

III. INFERENCES OF A UNITARY BUSINESS

A. *Same Type of Business.* Business activities that are in the same general line of business generally constitute a single unitary business, as, for example, a multistate grocery chain.

B. *Steps in a Vertical Process.* Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.

C. *Strong Centralized Management.* Business activities which might otherwise be considered as part of more than one unitary business may constitute one unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are

actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

IV. COMMONLY OWNED OR CONTROLLED GROUP OF BUSINESS ENTITIES

1. Separate corporations can be part of a unitary business only if they are members of a commonly controlled group.

2. A "commonly controlled group" means any of the following:

a. A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if-

(1). The parent owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,

(2) Stock cumulatively representing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph (A), or one or more other corporations that satisfy the conditions of this subparagraph.

b. Any two or more corporations, if stock representing more than 50 percent of the voting power of the corporations is owned, or constructively owned, by the same person.

c. Any two or more corporations that constitute stapled entities.

(1). For purposes of this paragraph, "stapled entities" means any group of two or more corporations if more than 50 percent of the ownership or beneficial ownership of the stock possessing voting power in each corporation consists of stapled interests.

(2). Two or more interests are stapled interests if, by reason of form of ownership restrictions on transfer, or other terms or conditions, in connection with the transfer of one of the interests the other interest or interests are also transferred or required to be transferred.

d. Any two or more corporations, all of whose stock representing more than 50 percent of the voting power of the corporations is cumulatively owned (without regard to the constructive ownership rules of paragraph (a) of subdivision (5)) by, or for the benefit of, members of the same family. Members of the same family are limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.

3. a. If, in the application of subdivision 2, a corporation is eligible to be treated as a member of more than one commonly controlled group of corporations, the corporation shall elect to be treated as a member of only one commonly controlled group. This election shall remain in effect unless revoked with the approval of the [state tax agency].

b. Membership in a commonly controlled group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subdivision 2 are not met, except as follows:

(1) When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a commonly controlled group shall not be terminated, if the requirements of subdivision (2) are again met immediately after the sale, exchange, or disposition.

(2) The [state tax agency] may treat the commonly controlled group as remaining in place if the conditions of subdivision (b) are again met within a period not to exceed two years.

4. A taxpayer may exclude some or all corporations included in a "commonly controlled group" by reason of paragraph d of subdivision 2 by showing that those members of the group are not controlled directly or indirectly by the same interests, within the meaning of the same phrase in Section 482 of the Internal Revenue Code. For purposes of this subdivision, the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.

5. Except as otherwise provided, stock is "owned" when title to the stock is directly held or if the stock is constructively owned.

a. An individual constructively owns stock that is owned by any of the following:

(1) His or her spouse.

(2) Children, including adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.
(3) An estate or trust, of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse or children.

b. Stock owned by a corporation, or a member of a controlled group of which the corporation is the parent corporation, is constructively owned by any shareholder owning stock that represents more than 50 percent of the voting power of the corporation.

c. Stock owned by a partnership is constructively owned by any partner, other than a limited partner, in proportion to the partner's capital interest in the partnership. For this purpose, a partnership is treated as owning proportionately the stock owned by any other partnership in which it has a tiered interest, other than as a limited partner.

d. In any case where a member of a commonly controlled group, or shareholders, officers, directors, or employees of a member of a commonly controlled group, is a general partner in a limited partnership, stock held by the limited partnership is constructively owned by a limited partner to the extent of its capital interest in the limited partnership.

6. For purposes of this definition, each of the following shall apply:

a. "Corporation" means a subchapter S corporation, limited liability company, any other incorporated entity, or any entity defined or treated as a corporation pursuant to [insert your State statute].

b. "Person" means an individual, a trust, an estate, a qualified employee benefit plan, a limited partnership, or a corporation.

c. "Voting power" means the power of all classes of stock entitled to vote that possess the power to elect the membership of the board of directors of the corporation.

d. "More than 50 percent of the voting power" means voting power sufficient to elect a majority of the membership of the board of directors of the corporation.

e. "Stock representing voting power" includes stock where ownership is retained but the actual voting power is transferred in either of the following manners:

(1) For one year or less.
(2) By proxy, voting trust, written shareholder agreement, or by similar device, where the transfer is revocable by the transferor.

7. The [state tax agency] may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section, including, but not limited to, regulations that do the following:

a. Prescribe terms and conditions relating to the election described by subdivision 3, and the revocation thereof.

b. Disregard transfers of voting power not described by paragraph e of subdivision 6.

c. Treat entities not described by paragraph b of subdivision 6 as a person.

d. Treat warrants, obligations convertible into stock, options to acquire or sell stock, and similar instruments as stock.

e. Treat holders of a beneficial interest in, or executor or trustee powers over, stock held by an estate or trust as constructively owned by the holder.

f. Prescribe rules relating to the treatment of partnership agreements which authorize a particular partner or partners to exercise voting power of stock held by the partnership.

Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Frank D. Katz, General Counsel and Hearing Officer for MTC Proposed Regulation Setting Forth Principles for Determining the Existence of a Unitary Business.

From: Loretta King, Administrative Assistant

Date: July 11, 2003

Subject: Certification of mailing of "**Notice Of Public Hearings Regarding Proposed Regulation Setting Forth Principles for Determining the Existence of a Unitary Business**"

In compliance with the Multistate Tax Commission Bylaw 7, the "Notice of Public Hearing Regarding Proposed Regulation Setting Forth Principles for Determining the Existence of a Unitary Business" was mailed on July 7, 2003, to the names on the mailing lists maintained by the MTC.

EXHIBIT C

HellerEhrman
ATTORNEYS

August 1, 2003

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99999.0102

Frank D. Katz
Multistate Tax Commission
444 N. Capitol Street, N.W.
Suite 425
Washington, D.C. 2001-1538

Re: Proposed Regulation on Determination of Existence of Unitary Business

Dear Mr. Katz:

I have reviewed your Proposed Regulation Setting Forth Principles for Determining the Existence of a Unitary Business and have the following comments regarding proposed Reg IV (Commonly Owned on Controlled Group of Business Entities). This language appears to adopt a California statute that defines unity of ownership. While I agree with the notion that the detailed definition provides useful, specific guidance, the mere presence of a comprehensive regulation can have a negative impact in the sense that a rigid definition may both promote creative tax planning and present potential traps for the unwary. But, assuming the section stays in the regulation:

a. In the first sentence of paragraph 6 of Section IV, the word "definition" should probably be changed to read "regulation."

b. See paragraph IV.6.b. Am I correct that the definition of "person" is intended to include only those entities listed and, for example, not include a foreign government?

c. The proposed definition prohibits combination where a "closely knit shareholder group of individuals," no single member owning more than 50%, forms two or more brother-sister corporations that engage in a unitary business. There appears to be no compelling policy reasons to exclude combination of such a group. I recommend that the regulation include such groups in the definition of commonly owned or controlled group.

d. See paragraph IV.6.e, defining "stock representing voting power;" and in particular the reference to voting trusts.

HellerEhrman
ATTORNEYS

First, consider the purpose of the section, which is to define unity of ownership. In my view, the real purpose of a unity of ownership requirement has nothing to do with identification of a unitary business. A unitary business is identified by considering actual taxpayer behavior, and that is the focus of the first three sections of the proposed regulation. The result of establishing a unitary business including two or more corporations is that taxable income is reallocated among the corporate members of the group. Tax liability of individual corporations are both increased and decreased. This shifting of the liability should only be done where there is a sufficiently similar ownership (which has come to be defined as more than 50%).

It seems to me that the California administrative treatment of voting trusts often reached the wrong result, usually by excluding combination when combination should result. For example, California has denied combination of a 100% owned subsidiary of a corporation that had significant foreign ownership, where the stock was held by three voting trustees for the sole purpose of qualifying for award of defense contracts. The Franchise Tax Board agreed that the subsidiary was engaged in a unitary business with the other 100% owned U.S. subsidiaries. The tax result in that case was that California tax revenue went up that year; however, the principles could just as readily result in a reduction in liability. If the corporations are in fact engaged in a unitary business and there is 100% identity in the beneficial ownership of the U.S. subsidiaries, there should be combination.

My specific suggestion is to revise subsection 6.3.(2) to read:

> By proxy, voting, trust, written shareholder agreement, or by similar devices, where the transfer is revocable by the transferor. A transfer is revocable if the owners of the beneficial interest in the transferred stock can revoke the transfer by unanimous agreement. The existence of the transfer is one of the factors to take into account in application of the other provisions of this regulation.

Addition of this language will tie tax liability to beneficial ownership of shares so that an agreement separating voting rights from beneficial ownership does not break unity of ownership where actual unitary relationships are not affected by the transfer of voting rights. At the same time, if a voting trust does in fact result in independent management of the corporation, a unitary business should be found not to exist.

Sincerely yours,

Roy E. Crawford
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M E M O R A N D U M

To: Frank Katz
Multistate Tax Commission
444 N. Capitol St. NW, Suite 425
Washington, D.C. 20001

Date: August 7, 2003

From: Michael Brownell

Subject: MTC Unitary Business Regulation

These are comments regarding the MTC Unitary Business Regulation, scheduled to be heard in Oakland, CA, on August 11, 2003. The comments are my own, and do not necessarily represent the views of the Chief Counsel, the Executive Officer, or the members of the Franchise Tax Board.

1. It is not clear how this regulation will fit within the existing MTC regulations. The regulation replaces and expands upon the prior version of MTC Reg. IV.1.(b). (before the recent amendments) which was part of the definition of business income. The current version is no longer contextually related to the definition of business income. Is regulation to be stand-alone, or is it to eventually be integrated under MTC Reg. IV.1.?

2. The subsection enumeration within the regulation is internally inconsistent. Section I., for example begins with a capital A., while Section IV begins with a numerical 1. In addition, the subsection enumeration in the regulation is inconsistent with the general enumeration used by the MTC in its standard regulations under UDITPA section 1-18. (Parenthetically, the enumeration used in the standard regulations also appears to be inconsistent with enumeration in the special regulations adopted under section 18.)

3. Sections I.A. and I.D. It is suggested that the phrase "commonly controlled group" be used in lieu of "commonly owned or controlled group" to be consistent with the term of art used in Section IV.

EXHIBIT E

4. Section II.B.1. Typographical error. The word "business's " should be "business'."

5. Section IV.2.a.(2). It is suggested that the term "possessing" be used in lieu of the term "representing" to avoid confusion that the different terms might suggest a different meaning from one another.

6. Section IV.2.a.(2). In the text, "subparagraph (A)" should be revised to read "subparagraph (1)" to be consistent with the operation of California Section 25105, from which it is modeled. Apparently the "A" was taken from the California enumeration, but does not reflect the enumeration used in the MTC regulation.

7. Section IV.2.b. Same as comment 5. above.

8. Section IV.2.d. Same as comment 5. above. It is suggested that the phrase "all of whose" be replaced with the word "if." The term "all," related to all of the corporations that qualify, is surplus, and possibility confusing in light of the more than 50% standard with respect to the portion of voting stock required to be owned by the members of the same family.

9. Section IV.3. This section deals with situations where a corporation might qualify for inclusion in two commonly controlled groups. It is suggested that the unitary business principle is furthered by having the multiply qualified corporation be associated with the group with respect to which it has a unitary relationship. As proposed, the election would only apply if the corporation were unitary with more than one group. It does not seem to be sound unitary tax policy to allow otherwise unitary taxpayers to effectively elect out of unity.

10. Section IV.3.b.(1). Enumeration "(2)" in the text was changed to "2" for consistency.

11. Section IV.3.b.(2). Enumeration "(b)" in the text was changed to "2" to be consistent with the operation of California Section 25105, from which it is modeled.

12. Section IV.5.c. (New). An amendment to the constructive ownership rules is appropriate in order to avoid a potential family member manipulation of the unity of ownership rules. To illustrate, assume that family members X, Y, and Z each own 20% of the stock of corporations A, B and C. Because the family owns more than 50% of all corporations, unity of ownership would be satisfied for all three. If the family members contribute the stock in Corporation C to Corporation A, unity of ownership would be satisfied with respect to Corporation A and C under the parent-subsidiary rule of IV.2.(1). Unity of ownership would also be satisfied with

respect to A and B under the family ownership rules of IV.d. But no single rule would include all three. A taxpayer seeking to resist combination of either B or C might attempt to rely on the election provisions of IV.3.a to force either an A-B combination or an A-C combination, but not all three. The proposed rule would eliminate this potential manipulation by applying constructive ownership rules to family members, even if no one of them has more than a 50% voting stock in a corporation, if the family ownership, in aggregate, exceeds 50%.

13. Section IV.5.d. (as renumbered). "Except as otherwise provided" is added to reflect a later exception to the limited partnership rules that follow below.

14. Section IV.5.f. (New). An amendment to the constructive ownership rules is necessary in order to avoid another potential family member manipulation of the unity of ownership rules. To illustrate, assume that Brothers A and B each own 30% of the stock of Corporations X and Y. The corporations would be in the same commonly controlled group under the family rules of IV.2.d. If Brother B contributes his stock to a limited partnership, with Brother A as the 1% general partner, unity of ownership would be arguably broken under the general rule of IV.5.d (as renumbered), because the constructive ownership rules do not normally apply through a limited partnership. The proposed rule would allow constructive ownership to pass through a limited partnership, but the pass-through rule would apply only in the context of unity of ownership resulting from stock owned by the same family under IV.2.d.

15. Section IV.6.a. The location of the limited liability company phrase is misplaced. A limited liability company can elect to be treated as a partnership or as a corporation. It is appropriate to treat a limited liability company as being a "corporation" only if it has made the corporate election. Thus, the new structure will apply corporate treatment to a limited liability company that in fact is treated as a corporation under state law.

16. Section IV.6.e. Same as comment 5.

17. Section IV.6.f. (New). This provides a rule to give a "voting stock" attribute to ownership instruments of entities that are not corporations and that may not issue stock, but that are treated as a corporation under the check-the-box system.

18. Section IV.6.g. (New). In most cases, there are very different results for partnerships, depending upon whether the partnership is a general partnership or a limited partnership. So called "check the box" entities may include entities that are not formally partnerships but elect partnership treatment, leaving uncertain whether such an entity should be treated as a general or limited partnership. This provision sets a default rule that would treat entities that check the box as partnerships as if they were a general partnership. However, recognizing that many check the box entities might more operate more like limited partnerships, this rule

would allow the state tax authorities to provide for limited partnership treatment if that is the appropriate result.

19. Section IV.7.g. This provision is suggested to provide for potential later authority to deal with other circumstances where limited partnerships are used as a device to avoid unity of ownership.

Please call if you have any questions.

Tax Counsel IV

Multistate Tax Commission

PROPOSED REVISION OF MULTISTATE TAX COMMISSION ALLOCATION AND APPORTIONMENT REGULATION IV.1(b) SETTING FORTH PRINCIPLES FOR DETERMINING THE EXISTENCE OF A UNITARY BUSINESS

Approved for Public Hearing by the
Executive Committee June 13, 2003
Revisions Recommended by the Hearing Officer
(with formatting and numbering changes)

••• Reg. IV.1.(b). Principles for Determining the Existence of a Unitary Business.

(1) Unitary Business Principle.

(A) *The Concept of a Unitary Business*. A unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly ~~owned or~~ controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. This flow of value to a business entity located in this state that comes from being part of a unitary business conducted both within and without this State is what provides the constitutional due process "definite link and minimum connection" necessary for this state to apportion business income of the unitary business, even if that income arises in part from activities conducted outside the state. The business income of the unitary business is then apportioned to this state using an apportionment percentage provided by **[insert your state statute]**.

This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contributes to the activities of another business *or* are dependent upon the activities of another business, those businesses are part of a unitary business.

EXHIBIT F

(B) *Constitutional Requirement for a Unitary Business.* The sharing or exchange of value described in subsection (A) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no *operational* relationship to the unitary business.

In this State, the unitary business principle shall be applied to the fullest extent allowed by the U.S. Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of such activities or entities would not be allowed by the U.S. Constitution.

(C) *Separate Trades or Businesses Conducted within a Single Entity.* A single entity may have more than one unitary business. In such cases it is necessary to determine the business, or apportionable, income attributable to each separate unitary business as well as its nonbusiness income, which is specifically allocated. The business income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

(D) *Unitary Business Unaffected by Formal Business Organization.* A unitary business may exist within a single business entity or among a ~~group of~~ commonly ~~owned or~~ controlled group of business entities. The scope of what is included in a commonly ~~owned or~~ controlled group of business entities is set forth in Section V below.

(2) Determination of a Unitary Business

(A) A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. [RESERVED: See regulation concerning passive holding companies for special rules that govern the determination of whether a pure or passive holding company constitutes a part of a unitary business with one or more affiliates conducting active business operations.] Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation. A particular business op-

eration may be suggestive of one or more of the factors mentioned above.

(B) *Description and Illustration of Functional Integration, Centralization of Management and Economies of Scale.*

1. *Functional integration:* Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that can support the finding of functional integration. The order of the list does not establish a hierarchy of importance.

    a. Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and/or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among business entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales, because such sales can represent an assured market for the seller or an assured source of supply for the purchaser.

    b. *Common Marketing.* The sharing of common marketing features among business entities is an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the business entities' products, services, or intangibles are distributed or sold to a common customer, when the business entities use a common trade name or other common identification, or when the business entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. (Such ac-

tivity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)

c. *Transfer or Pooling of Technical Information or Intellectual Property*. Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development, provide evidence of functional integration when the matter transferred is significant to the businesses' operations.

d. *Common Distribution Syste*m. Use of a common distribution system by the business entities, under which inventory control and accounting, storage, trafficking, and/or transportation are controlled through a common network provides evidence of functional integration.

e. *Common Purchasin*g. Common purchasing of substantial quantities of products, services, or intangibles from the same source by the business entities, particularly where the purchasing results in significant cost savings or where the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, provides evidence of functional integration.

f. *Common or Intercompany Financin*g. Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business entities for the benefit of another business entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender does not necessarily provide evidence of functional integration. *(See* below for discussion of centralization of management.)

2. *Centralization of Management.* Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single business entity to another division within a business entity,

or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

a. *Facts Providing Evidence of Centralization of Management.* Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are common directors.

b. *Stewardship Distinguished.* Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.

3. *Economies of Scale.* Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that can support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.

a. *Centralized Purchasing.* Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of

purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.

b. *Centralized Administrative Functions.* The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit administration, in common among the parts of the business may result in some degree of economies of scale. A business entity that secures savings in the performance of corporate administrative services due to its affiliation with other business entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, provides evidence of economies of scale.

(3) Inferences of a Unitary Business.

(A) *Same Type of Business.* Business activities that are in the same general line of business generally constitute a single unitary business, as, for example, a multistate grocery chain.

(B) *Steps in a Vertical Process.* Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.

(C) *Strong Centralized Management.* Business activities which might otherwise be considered as part of more than one unitary business may constitute one unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal mat-

ters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

(4) Commonly ~~OWNED OR~~ Controlled Group of Business Entities.

(A) Separate corporations can be part of a unitary business only if they are members of a commonly controlled group.

(B) A "commonly controlled group" means any of the following:

1. A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if--

   a. The parent owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,

   b. Stock cumulatively ~~representing~~ possessing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph a, or one or more other corporations that satisfy the conditions of this subparagraph.

2. Any two or more corporations, if stock ~~representing~~ possessing more than 50 percent of the voting power of the corporations is owned, or constructively owned, by the same person.

3. Any two or more corporations that constitute stapled entities.

   a. For purposes of this paragraph, "stapled entities" means any group of two or more corporations if more than 50 percent of the ownership or beneficial ownership of the stock possessing voting power in each corporation consists of stapled interests.

   b. Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of the interests the other interest or interests are also transferred or required to be transferred.

4. Any two or more corporations, ~~all of whose~~ if stock ~~representing~~ possessing more than 50 percent of the voting power of the corporations is cumulatively owned (without regard to the constructive ownership rules of paragraph 1 of subsection (E) by, or for the benefit of, members of the same family. Members of the same family are

limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.

(C) 1. If, in the application of subsection (B), a corporation is ~~eligible to be treated as~~ a member of more than one commonly controlled group of corporations, the corporation shall elect to be treated as a member of only ~~one~~ the commonly controlled group (or part thereof) with respect to which it has a unitary business relationship. If the corporation has a unitary business relationship with more than one of those groups, it shall elect to be treated as a member of only one of the commonly controlled groups with respect to which it has a unitary business relationship. This election shall remain in effect until the unitary business relationship between the corporation and the rest of the members of its elected commonly controlled group is discontinued, or unless revoked with the approval of the [state tax agency].

2. Membership in a commonly controlled group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subsection (B) are not met, except as follows:

a. When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a commonly controlled group shall not be terminated, if the requirements of subsection (B) are again met immediately after the sale, exchange, or disposition.

b. The [state tax agency] may treat the commonly controlled group as remaining in place if the conditions of subsection B are again met within a period not to exceed two years.

(D) A taxpayer may exclude some or all corporations included in a "commonly controlled group" by reason of paragraph 4 of subsection (B) by showing that those members of the group are not controlled directly or indirectly by the same interests, within the meaning of the same phrase in Section 482 of the Internal Revenue Code. For purposes of this subsection, the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.

(E) Except as otherwise provided, stock is "owned" when title to the stock is directly held or if the stock is constructively owned.

1. An individual constructively owns stock that is owned by any of the following:

   a. His or her spouse.

   b. Children, including adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.

   c. An estate or trust, of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse or children.

2. Stock owned by a corporation, or a member of a controlled group of which the corporation is the parent corporation, is constructively owned by any shareholder owning stock that represents more than 50 percent of the voting power of the corporation.

3. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), if more than 50% of the stock possessing voting power of a corporation is, in the aggregate, owned by or for the benefit of members of the same family, stock owned by that corporation shall be treated as constructively owned by members of that family in the same ratio as the proportion of their respective ownership of stock possessing voting power in that corporation to all of such stock of that corporation.

4. Except as otherwise provided, Sstock owned by a partnership is constructively owned by any partner, other than a limited partner, in proportion to the partner's capital interest in the partnership. For this purpose, a partnership is treated as owning proportionately the stock owned by any other partnership in which it has a tiered interest, other than as a limited partner.

5. In any case where a member of a commonly controlled group, or shareholders, officers, directors, or employees of a member of a commonly controlled group, is a general partner in a limited partnership, stock held by the limited partnership is constructively owned by a limited partner to the extent of its capital interest in the limited partnership.

6. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), stock held by a limited partnership is constructively owned by a

limited partner to the extent of the limited partner's capital interest in the limited partnership.

(F) For purposes of ~~this~~ the definition of a commonly controlled group, each of the following shall apply:

1. "Corporation" means a subchapter S corporation, ~~limited liability company~~,any other incorporated entity, or any entity defined or treated as a corporation (including but not limited to a limited liability company) pursuant to [insert your State statute].

2. "Person" means an individual, a trust, an estate, a qualified employee benefit plan, a limited partnership, or a corporation.

3. "Voting power" means the power of all classes of stock entitled to vote that possess the power to elect the membership of the board of directors of the corporation.

4. "More than 50 percent of the voting power" means voting power sufficient to elect a majority of the membership of the board of directors of the corporation.

5. "Stock ~~representing~~ possessing voting power" includes stock where ownership is retained but the actual voting power is transferred in either of the following manners:

   a. For one year or less.

   b. By proxy, voting trust, written shareholder agreement, or by similar device, where the transfer is revocable by the transferor.

6. In the case of an entity treated as a corporation under paragraph 1 of subsection (F), "stock possessing voting power" refers to an instrument, contract, or similar document demonstrating an ownership interest in that entity that confers power in the owner to cast a vote in the selection of the management of that entity.

7. In the general application of this section, if an entity may elect to be treated as a partnership or as a corporation under the laws of this state (or under Section 7701 of the Internal Revenue Code), and elects to be treated as a partnership, that entity shall be treated as a general partnership. If, however, contractual agreements, member agreements, or other restrictions limit the power of some or all of the members to participate in the vote of stock possessing voting

power owned by that entity (similar to the restrictions of limited partners in a limited partnership) [the state taxing agency] may permit or require that entity to be treated as a limited partnership.

(G)The [state tax agency] may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section, including, but not limited to, regulations that do the following:

1. Prescribe terms and conditions relating to the election described by subsection (C), and the revocation thereof.

2. Disregard transfers of voting power not described by paragraph 5 of subsection (F).

3. Treat entities not described by paragraph 2 of subsection (F) as a person.

4. Treat warrants, obligations convertible into stock, options to acquire or sell stock, and similar instruments as stock.

5. Treat holders of a beneficial interest in, or executor or trustee powers over, stock held by an estate or trust as constructively owned by the holder.

6. Prescribe rules relating to the treatment of partnership agreements which authorize a particular partner or partners to exercise voting power of stock held by the partnership.

7. Treat limited partners as constructive owners of stock possessing voting power held by the limited partnership, in proportion to their interest in the partnership.